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### **Crossroads**

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The State Bank in its quarterly report released last week, raised concern regarding the possibility of a fall in GDP growth level below the 7.2% target to almost 6.6%. Amid political uncertainty and increasing economic challenges in terms of a rising current account and fiscal deficit, escalating prices in the wake of rising international food and energy prices, and a persisting power, wheat and cotton crisis, the economy is rather standing at new crossroads.

This report will critically analyze the performance of the economy for the first half of the current fiscal year, FY 2007-08, before concluding an outlook for the second half.

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## **2007: Year of Political and Economic Turmoil**

The year 2007 was stained with a set of destabilizing factors as our country witnessed upheaval in the judiciary, imposition of emergency and a provincial constitutional order, media censorship and continued agitation by lawyers and journalists coupled with the rise in religious fundamentalism and militancy in tribal and adjoining settled areas. Among the series of these fateful events, the assassination of Benazir Bhutto on Dec 27th, less than two weeks before parliamentary elections came as the biggest and the final blow to the political arena of Pakistan for the year. This has sparked extreme violence across much of the country and elections have been rescheduled for Feb 18<sup>th</sup>, 2008.

Due to the inherent association between politics and economic growth, it is no surprise that the economy has suffered severely at the hands of the political turmoil and civil strife. The political uncertainty ahead of the approaching elections has hurt the investor sentiment significantly and millions of dollars have been channeled out time and again from the equity markets. At the same time the economy faces additional challenges due to uncertainties in not only the domestic but also the international economic setting in the form of rising trade, current account and budget deficits, unprecedented increase in oil prices in international market, electricity, wheat and cotton crisis and most importantly high food inflation.

In the presence of this political and thereby economic mayhem the State Bank of Pakistan has clearly stated the possibility of missing the 7.2% growth target for the current financial year, FY08. Simultaneously the economy is expected to exceed the inflation target of 6.5% and the fiscal deficit target of 4.0% of GDP for the year. In the following pages, we will present a critical review of the economy for the first half of the current fiscal year before concluding an outlook for the second half.

### **Economic Review: First Half of FY 2007-08**

#### **Monetary Developments**

Concerned with the rising uptrend in core inflation, and the risk of inflationary pressures emanating from a rise in monetary aggregates towards the end of the previous fiscal year, FY07, the SBP further tightened its monetary stance, raising its policy discount rate by 50 bps to 10% on Aug 1<sup>st</sup> 2007. In addition to this, the SBP restructured the Export Refinancing Scheme (EFS) whereby the commercial banks were obligated to provide 30% of EFS at the existing rate of 7.5% from their own resources. The SBP also suggested a quarterly ceiling on budgetary borrowing with a greater focus on long term debt.

These policy measures substantially reduced the growth in the reserve money during Jul-29<sup>th</sup> December FY08 period as reserve money growth was recorded at 10.99% against a growth of 15.61% for the corresponding period of the previous year. The growth in broad monetary aggregate (M2) remained at 7.17 % against growth of 6.89% recorded for the corresponding period of FY07. The expansion in broad money was entirely a result of a rise in net domestic assets (NDA) of the banking system, as the net foreign assets (NFA) registered a decline during the period (Figure 1).

**Figure 1: Monetary Aggregates for the week ended 5<sup>th</sup> Jan'08**

| COMPONENTS                                |  | Stocks at End-June 2007 | Yearly Flows   |                 |                | Monetary Impact Since |                |
|---|--|-------------------------|----------------|-----------------|----------------|-----------------------|----------------|
|   |  |                         | FY 05          | FY 06           | FY 07          | 1st July to           |                |
|   |  |                         |                |                 |                | 5-Jan-08 <sup>P</sup> | 6-Jan-07       |
| <b>A</b>                                  | Currency in Circulation                                  | 840,181                 | 87,785         | 74,489          | 99,790         | 166,134               | 131,857        |
| <b>B</b>                                  | Other Deposits with SBP                                  | 7,012                   | 1,219          | 1,595           | 2,081          | -1,845                | -268           |
| <b>C</b>                                  | Total Demand & Time Deposits incl. RFCDs <sup>1</sup>    | 3,217,962               | 386,148        | 370,176         | 556,378        | 127,278               | 103,210        |
|   | of which Residents Foreign Currency Deposits (RFCDs)     | 207,312                 | 34,600         | 15,206          | 11,811         | 15,221                | 3,218          |
|   | <b>Broad Money (M2)</b>                                  | <b>4,065,155</b>        | <b>475,152</b> | <b>446,260</b>  | <b>658,250</b> | <b>291,567</b>        | <b>234,799</b> |
|   | <b>Growth</b>  |                         | <b>19.12%</b>  | <b>15.07%</b>   | <b>19.32%</b>  | <b>7.17%</b>          | <b>6.89%</b>   |
| <b>Factors Affecting Broad Money (M2)</b> |  |                         |                |                 |                |                       |                |
| <b>A</b>                                  | <u>Net Foreign Assets of the Banking System</u>          | <u>984,892</u>          | <u>53,748</u>  | <u>73,403</u>   | <u>274,551</u> | <u>-139,194</u>       | <u>-15,875</u> |
| <b>B</b>                                  | <u>Net Domestic Assets of the Banking System (1+2+3)</u> | <u>3,080,263</u>        | <u>421,404</u> | <u>372,857</u>  | <u>383,699</u> | <u>430,761</u>        | <u>250,674</u> |
|   | <b>Growth</b>  |                         | <b>22.15%</b>  | <b>16.05%</b>   | <b>14.23%</b>  | <b>13.98%</b>         | <b>9.30%</b>   |
| <b>1</b>                                  | <u>Net Government Sector Borrowings (a+b+c)</u>          | <u>926,530</u>          | <u>91,141</u>  | <u>86,879</u>   | <u>92,844</u>  | <u>215,573</u>        | <u>44,966</u>  |
| <b>a</b>                                  | <b>Borrowings for Budgetary Support</b>                  | 810,053                 | 67,152         | 67,063          | 102,015        | 243,942               | 63,497         |
|   | (i) From SBP   | 344,991                 | 155,588        | 135,092         | -58,575        | 222,129               | 112,222        |
|   | (ii) From Scheduled banks                                | 465,061                 | -88,435        | -68,029         | 160,590        | -21,814               | -48,725        |
| <b>b</b>                                  | Commodity Operations                                     | 98,552                  | 21,963         | 19,926          | -9,210         | -27,333               | -17,120        |
| <b>c</b>                                  | Others   | 17,926                  | 2,026          | -110            | 39             | -1,037                | -1,411         |
| <b>2</b>                                  | <u>Credit to Non-Government Sector (a+b+c+d)</u>         | <u>2,576,474</u>        | <u>418,699</u> | <u>408,401</u>  | <u>385,705</u> | <u>252,277</u>        | <u>222,135</u> |
| <b>a</b>                                  | Credit to Private Sector                                 | 2,479,608               | 437,848        | 401,797         | 365,718        | 246,202               | 225,255        |
| <b>b</b>                                  | Credit to Public Sectors Enterprises (PSEs)              | 104,158                 | -11,083        | 7,154           | 19,942         | 4,982                 | -4,856         |
| <b>c</b>                                  | PSEs Special Account-Debt Repayment with SBP             | -23,478                 | -1,606         | 489             | -253           | -25                   | -194           |
| <b>d</b>                                  | Other Financial Institutions (SBP credit to NBFIs)       | 16,187                  | -6,460         | -1,038          | 298            | 1,118                 | 1,930          |
| <b>3</b>                                  | <u>Other Items (net)</u>                                 | <u>-422,742</u>         | <u>-88,436</u> | <u>-122,423</u> | <u>-94,850</u> | <u>-37,089</u>        | <u>-16,428</u> |
|   | <b>Broad Money (M2)</b>                                  | <b>4,065,155</b>        | <b>475,152</b> | <b>446,260</b>  | <b>658,250</b> | <b>291,567</b>        | <b>234,799</b> |
|   | <b>Growth</b>  |                         | <b>19.12%</b>  | <b>15.07%</b>   | <b>19.32%</b>  | <b>7.17%</b>          | <b>6.89%</b>   |

<sup>P</sup>: Provisional

Source: SBP

Though the monetary tightening has been successful in moderating the rise in private sector credit growth, the impact of this temperance on M2 growth was more than offset by continued strong budgetary borrowings from the banking system during this period. As of 5<sup>th</sup> Jan-08, total budgetary borrowing rose to PKR 222 billion; up almost six times over the borrowing for same period last year. Of this, the major portion was sourced directly from the SBP, while the banking sector picked up only 8% of the total



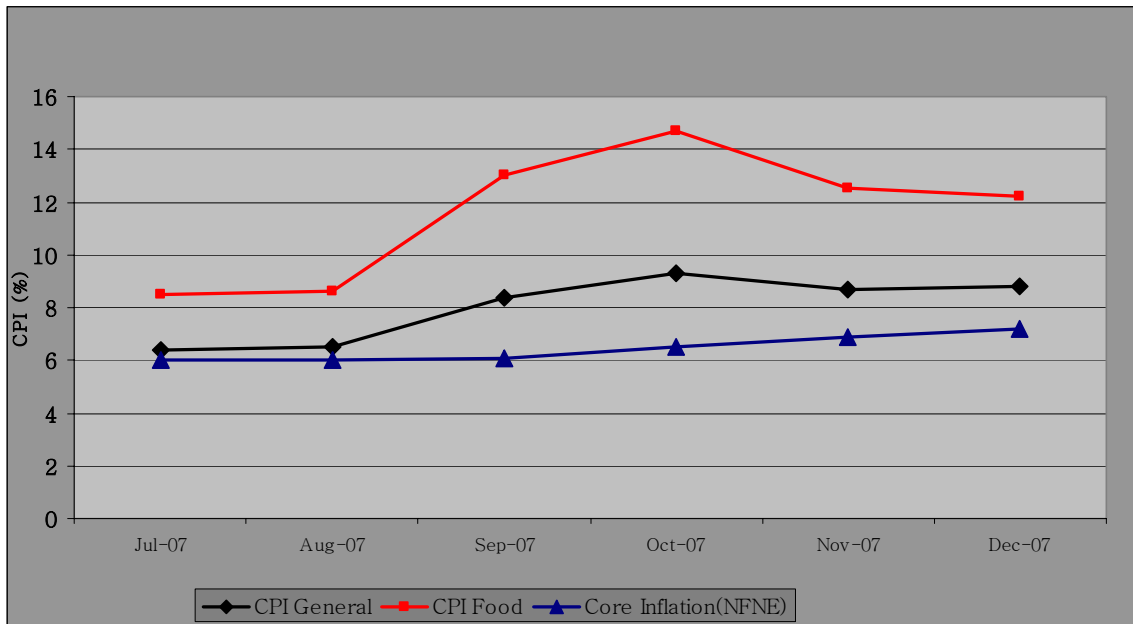
government debt. This is in contravention of SBP's directives given in its Monetary Policy Statement, where the government was advised to shift the bulk of its debt financing towards the banking sector since increased government borrowings from the central bank have an inflationary impact and thereby tend to dilute the impact of monetary policy.

### Prices

The monetary tightening pursued during the year was meanwhile successful in reducing non food inflation but its impact on headline CPI inflation (a measure which assigns 40% weight to food inflation) was offset, particularly in the last three months, due to sustained increases in global food and energy commodity prices and continued strength of domestic demand. The rise in all price indices in recent months clearly reflects this.


The average headline inflation for the first two months of FY08 was recorded at 6.4%. However, in the months that followed inflationary pressures began to rise on the back of rising international food (particularly wheat, rice and milk) and oil prices, causing the general CPI level to rise substantially. Food inflation reached double digits in Sept-07 and skyrocketed to a 30 month high in Oct-07 at 14.7%. Subsequently headline CPI inflation resurged sharply to reach a 29 month high at 9.3% in Oct-07.

**Figure 2: Headline, Food and Core Inflation Measures**



It is interesting to note that since the beginning of FY08 core inflation has also been gradually increasing. This is because the prices of a broader range of CPI basket is now





being impacted by the cost push of high commodity prices, as suppliers of goods and services increased prices to protect margins.

### **Fiscal Developments**

The increased government borrowings witnessed in the recent months are associated with increased government expenditure. Strong increases have been witnessed in both development and current spending by the government. The development expenditure grew by 89.5% during the first quarter alone while the current expenditures registered a high growth of 39.2 % due to an over 100% rise in debt servicing cost. Subsidy disbursements are also likely to be well above budgetary provisions.

On the revenue side, a remarkable growth was seen in non tax revenue which increased on account of a sharp rise in SBP profits and interest income. However growth in tax revenues declined to 12.5% relative to the previous year on account of lower growth of direct taxes. The total government revenue therefore failed to match the increased government spending. On the whole, in FY08 all fiscal indicators have worsened substantially.


### **The External Account**

The key challenge facing the economy's external account is the rising current account deficit while the capital and the financial accounts have performed reasonably well in the first five months of FY08.

The current account deficit for Jul-Nov period FY08 stands at USD 4.798 billion against a deficit of USD 4.367 billion for the corresponding period of the previous year. Though the export receipts showed a growth of 8% over the same period last year, the 10% growth in imports more than offset the impact on current account. The export base remained narrow with semi-manufactures and manufactures products constituting over 89% of total exports while imports were heavily skewed towards petroleum products, capital goods and other industrial raw materials.

### **Economic Outlook: Where are we Heading?**

Amid political uncertainty and increasing economic challenges in terms of a rising current account and fiscal deficit, escalating prices in the wake of rising international food and energy prices, and a persisting power, wheat and cotton crisis, the outlook for the economy in the coming months is not so bright. In its quarterly report released last week, the SBP raised concern regarding the possibility of a fall in GDP growth level below the 7.2% target to almost 6.6%. Cynics expect GDP for FY08 to be even below the 6.6% level, arguing that SBP estimate did not capture the data of the fall in industrial



output and trade activity following Bhutto's assassination. Hence GDP growth may in fact be even lower than 6.6%.

Nevertheless we believe that today the fundamentals are strong enough to withstand the current political and economic uncertainties. Though we do acknowledge that economic growth will slowdown and the coming months will present a crucial challenge for the policy makers as political turmoil and unprecedented inflation will continue to take their toll on investor confidence and the economy.

In this section of the report we shall examine our outlook on the economic fundamentals in the remaining months of the current fiscal year.

### **Monetary Policy: Another Rate Hike?**


A key challenge facing the economy today, besides political uncertainty, is the unprecedented rise in inflation. Inflation in recent months has been driven by rising international food and energy prices and supply inefficiencies in the domestic markets particularly for wheat and rice. This raises questions regarding the need for another rate hike by the SBP, since discount rate impacts only the demand side inflationary pressures. However, the risks of renewed inflationary pressures in the economy as a result of the high commodity prices and the continued strength in M2 growth rate are a source of concern for the central bank. These developments in fact suggest that a tight monetary stance is a prudent choice to curb any further spread of inflationary pressures into the economy. Therefore we believe that in its upcoming Monetary Policy Statement, the SBP will maintain a tight monetary stance; chances always being there of a discount rate hike by up to 50 bps.

At the same time, the government must execute proactive measures to contain food inflation which particularly affects the low-income groups. Though, going forward, domestic prices of wheat, oil, rice and vegetables are likely to stabilize after resurgence in the global output and domestic supply, pressures on the prices of edible oil and dairy products are likely to persist. Therefore, policy responses are needed to increase the levels of domestic production and productivity of these items in particular.

Nonetheless it must be noted that the government has already been providing substantial relief via provision of key staples at subsidized rates through utility stores. Any further relief measures in the short term mean increased costs on the national exchequer.

### **Fiscal Discipline: Can the Government uphold it?**

As mentioned earlier, all fiscal indicators have worsened substantially in the current fiscal year. The government has incurred spending beyond budgetary provisions and therefore has borrowed heavily from the central bank.



In the coming months we expect current expenditure to exceed fiscal estimates. This is because we are likely to witness a rise in subsidies in the wake of rising fuel and energy prices and food items like wheat and rice, an increase in debt servicing and a probable increase in defense spending in view of current law and order scenario in the country. Further, in the absence of any consequential tax reforms, the government is unlikely to meet its revenue collection target. Hence we expect the government to exceed its budget deficit target of 4.0% of GDP by approximately 50 to 75 bps.

### **Current Account: A Weakness Yet Again!**


This year again, the current account deficit is likely to present a key challenge to macroeconomic stability. We expect the current account deficit to exceed its year end target of 4.9% of GDP as we expect the imports payments to exceed export receipts significantly. Imports are likely to rise in the face of escalating oil prices; the oil import bill for the first 5 months stands at USD 3.7 billion and expected to increase two fold when accounted for the increased oil prices. An additional push is yet to strike the import basket from increased wheat imports. Due to the wheat shortage in the market and thereby high wheat prices, the government intends to import approximately 1 Million tones of wheat in the coming months.

The rising current account deficit is therefore the biggest challenge for the external account as a whole. It will be all the more difficult to sustain the deficit with increased pressure on foreign exchange reserves, huge outflows from the Special Convertible Rupee Accounts and a weakening rupee against the dollar in the face of political uncertainty. The uncertain and fast changing political scenario and worst law and order situation in most parts of the country has provoked investors across the globe to minimize their portfolios on board as reflected by the huge outflows from SCRA in recent months. The remittances have also declined; fell by USD 80 million in Nov-07 from its previous month. Further, any delay or substantial decline in privatization proceeds from GDRs and TFC issues could aggravate the external account situation. However we believe that these are rather short term reactions to political uncertainties and do not necessarily imply extension into the longer run.

Therefore we expect the external account to balance due to inflows from Foreign Direct Investment (FDI) and home Remittances. On the whole, FDI grew by 16% in the first 5 months of FY08 while remittances recorded a growth of over 23%.

### **Pakistan: Will the Picture get better or worse?**

While concerns on inflation and political stability grip the economy, we believe that these factors will be short lived. The economic fundamentals today are much stronger than they



were almost a decade ago and therefore will help the economy withstand its current challenges. Moreover if elections do proceed smoothly and we are able to establish democracy, we will see economic growth pick momentum yet again, supported by increased investor confidence. However the coming months will present a crucial challenge for the policy makers as well.

Two issues which will need immediate attention of the government and the respective sectors are sustained increases in food prices and a rising fiscal deficit. It is very crucial that the government make an effort to contain the fiscal deficit target as this would send a strong signal of the government's commitment to fiscal discipline and macroeconomic stability on the global front including the international rating agencies. Any corrective measures aimed at containing the fiscal deficit will automatically cool the price rise as well.

In the end we would like to reiterate that long term prospects will depend upon the interaction of evolution in political and social developments, economic policies to be pursued, the quality of governance and institutions, and investment in the human capital. Sustained economic growth and poverty reduction, thus, cannot take place merely on the strength of economic policies. Political stability, supporting institutions, and good governance are equally important ingredients coupled with both external environments for achieving economic success.



## Economic Snapshot

| Fiscal year 07-08              |          |        |        |        |        |        |        |        |        |        |        |        |        |        |
|--------------------------------|----------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
|                                | Units    | Dec    | Jan    | Feb    | March  | April  | May    | June   | July   | Aug    | Sep    | Oct    | Nov    | Dec    |
| <b><u>Inflation</u></b>        |          |        |        |        |        |        |        |        |        |        |        |        |        |        |
| Headline Inflation             | %        | 8.88   | 6.64   | 7.39   | 7.67   | 6.9    | 7.4    | 7.0    | 6.4    | 6.5    | 8.4    | 9.3    | 8.7    | 8.8    |
| Core inflation                 | %        | 5.5    | 5.3    | 5.72   | 5.42   | 5.2    | 4.7    | 5.1    | 6.0    | 6.0    | 6.1    | 6.5    | 6.9    | 7.2    |
| Food inflation                 | %        | 12.71  | 8.7    | 9.99   | 10.74  | 9.4    | 11.3   | 9.7    | 8.5    | 8.6    | 13     | 14.7   | 12.5   | 12.2   |
| Non-food inflation             | %        | 6.22   | 5.2    | 5.59   | 5.54   | 5.2    | 4.7    | 5.1    | 4.9    | 4.9    | 5      | 5.4    | 5.9    | 6.3    |
| <b><u>T-bill (Wgt Avg)</u></b> |          |        |        |        |        |        |        |        |        |        |        |        |        |        |
| 3 month                        | %        | 8.64   | 8.64   | 8.64   | 8.65   | 8.69   | 8.69   | 8.69   | 8.69   | 9.05   | 9.05   | 9.05   | 9.05   | 9.09   |
| 6 month                        | %        | 8.81   | 8.81   | 8.81   | 8.82   | 8.9    | 8.9    | 8.9    | 8.9    | 9.12   | 9.12   | 9.12   | 9.21   | 9.29   |
| 12 month                       | %        | 9.00   | 9.00   | 9.01   | 9.01   | 9.08   | 9.10   | 9.16   | 9.16   | 9.39   | 9.39   | 9.39   | 9.4    | 9.49   |
| <b><u>External Sector</u></b>  |          |        |        |        |        |        |        |        |        |        |        |        |        |        |
| Export                         | Mln US\$ | 1,536  | 1,227  | 1,421  | 1,536  | 1,446  | 1,540  | 1,583  | 1,434  | 1,475  | 1,463  | 1,593  | 1,524  | n.a    |
| Import                         | Mln US\$ | 2,365  | 2,100  | 2,103  | 2,070  | 2,159  | 2,190  | 2,373  | 2,423  | 2,206  | 2,150  | 2,555  | 2,864  | n.a    |
| Trade balance                  | Mln US\$ | (829)  | (873)  | (682)  | (534)  | (713)  | (650)  | (790)  | (989)  | (731)  | (687)  | (962)  | (1340) | n.a    |
| <b><u>Remittances</u></b>      | Mln US\$ | 475    | 391    | 457    | 520    | 513    | 537    | 505    | 495    | 489    | 516    | 580    | 505    |        |
| <b><u>Forex Reserves</u></b>   | Mln US\$ | 12,960 | 13,212 | 13,378 | 13,624 | 13,661 | 13,778 | 15,182 | 15,723 | 16,106 | 16,145 | 16,354 | 15,807 | 15,604 |



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